JOE BACA: WHEN WAS IT BROKEN?

Joe Baca (D-CA) asked Ben Bernanke a very simple question in today's House Financial Services hearing on AIG: When was AIG broken? When did it get so screwed up that we would have to bail it out.

Bernanke, however, didn't give Baca a clear answer. He did say this:

> The Office of Thrift Supervision is a small agency that specializes in addressing the problems of thrifts. It was, in this case, involved only because AIG owned a small thrift. It's main concern is the protection of the thrift. It's true, as [Polakoff] said, that he looked at some of these elements in the AIGFP division. But I do think that, given the size of the company and the risks being taken, a larger, more effective, stronger, better funded regulatory effort would have been needed in order to identify these problems.

What Bernanke didn't want to say was:

> 1999. When Congress dismantled the regulation on this kind of gambling.

Matt Taibbi explained it in more depth. First, he talked about Glass-Steagall (~~passed~~ killed with Gramm-Leach in 1999 [oops, gotta pay attention when I try to clarify]), that made it possible for insurance companies to dress up as trading firms. Then, he explained that Gramm pushed through the Commodity Futures Modernization Act (in 2000), which made it impossible to regulate CDS.

> The blanket exemption meant that Joe Cassano could now sell as many CDS contracts as he wanted, building up as

> huge a position as he wanted, without anyone in government saying a word. "You have to remember, investment banks aren't in the business of making huge directional bets," says the government source involved in the AIG bailout. When investment banks write CDS deals, they hedge them. But insurance companies don't have to hedge. And that's what AIG did. "They just bet massively long on the housing market," says the source. "Billions and billions."

Then, another bit of 1999 deregulation made it easy for huge companies like AIG to select to be regulated by the undermanned Office of Thrift Supervision (the one that Bernanke talks about above).

> In the biggest joke of all, Cassano's wheeling and dealing was regulated by the Office of Thrift Supervision, an agency that would prove to be defiantly uninterested in keeping watch over his operations. How a behemoth like AIG came to be regulated by the little-known and relatively small OTS is yet another triumph of the deregulatory instinct. Under another law passed in 1999, certain kinds of holding companies could choose the OTS as their regulator, provided they owned one or more thrifts (better known as savings-and-loans). Because the OTS was viewed as more compliant than the Fed or the Securities and Exchange Commission, companies rushed to reclassify themselves as thrifts. In 1999, AIG purchased a thrift in Delaware and managed to get approval for OTS regulation of its entire operation.
>
> Making matters even more hilarious, AIGFP — a London-based subsidiary of an American insurance company — ought to have been regulated by one of Europe's more stringent regulators, like

> Britain’s Financial Services Authority. But the OTS managed to convince the Europeans that it had the muscle to regulate these giant companies. By 2007, the EU had conferred legitimacy to OTS supervision of three mammoth firms — GE, AIG and Ameriprise.
>
> That same year, as the subprime crisis was exploding, the Government Accountability Office criticized the OTS, noting a "disparity between the size of the agency and the diverse firms it oversees." Among other things, the GAO report noted that the entire OTS had only one insurance specialist on staff — and this despite the fact that it was the primary regulator for the world’s largest insurer!

Finally, Taibbi described how the guy in charge of overseeing AIG concluded the CDS were harmless—solely on AIG’s say-so.

> When AIG finally blew up, the OTS regulator ostensibly in charge of overseeing the insurance giant — a guy named C.K. Lee — basically admitted that he had blown it. His mistake, Lee said, was that he believed all those credit swaps in Cassano’s portfolio were "fairly benign products." Why? Because the company told him so. "The judgment the company was making was that there was no big credit risk," he explained. (Lee now works as Midwest region director of the OTS; the agency declined to make him available for an interview.)

See, Ben Bernanke could have offered Congressman Baca a very simple answer: 1999. But if he did so, he’d have to admit that the answer to "when was it broken" is "when Phil Gramm and friends deregulated everything." And for some reason, Bernanke didn’t want to give such a clear answer.